



Notre Dame Law Review

Volume 88 | Issue 3

Article 8

2-1-2013

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Andrew A. Schwartz

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Recommended Citation

Andrew A. Schwartz, *Crowdfunding Securities*, 88 Notre Dame L. Rev. 1457 (2013).

Available at: <http://scholarship.law.nd.edu/ndlr/vol88/iss3/8>

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CROWDFUNDING SECURITIES

Andrew A. Schwartz*

A new federal statute authorizes the online “crowdfunding” of securities, a new idea based on the concept of “reward” crowdfunding practiced on Kickstarter and other websites. This method of selling securities had previously been banned by federal securities law but the new CROWDFUND Act overturns that prohibition.

This Article introduces the CROWDFUND Act and explains that it can be expected to have two primary effects on securities law and capital markets. First, it will liberate startup companies to use peer networks and the Internet to obtain modest amounts of capital at low cost. Second, it will help democratize the market for financing speculative startup companies and allow investors of modest means to make investments that had previously been offered solely to wealthy, so-called “accredited” investors.

This Article also offers two predictions as to how securities crowdfunding will play out in practice. First, it predicts that companies that sell equity via crowdfunding may find themselves the subject of hostile takeovers (though the founders of such companies can easily avoid that outcome if they act with a little foresight). Second, it predicts that issuers may prefer to crowdfund debt securities, such as bonds, rather than equity. The Article concludes with a few thoughts on the SEC’s implementation of the Act in light of the potential for fraud.

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* Associate Professor of Law, University of Colorado Law School. For helpful comments on prior drafts, I thank Frederic Bloom, Jon Coates, Erik Gerding, Jill Fisch, Victor Fleischer, Mark Loewenstein, Jason Mendelson, John Metzger, Dale Oesterle, Paul Ohm, Usha Rodrigues, Karen Schulz, Allison Schwartz, Jeremy Schwartz, Randall Thomas and Urska Velikonja, as well as participants at the 2012 Ohio State Entrepreneurial Business Law Journal symposium on securities regulation. For useful research assistance, I thank Nate Goergen and Emily Wasserman. This Article is dedicated to the memory of the twelve young victims whose lives were senselessly cut short last summer by a gunman in a movie theater in nearby Aurora, Colorado.

INTRODUCTION

The new federal CROWDFUND Act authorizes the “crowdfunding” of securities, defined as the sale of unregistered securities over the Internet to large numbers of retail investors, each of whom only invests a small dollar amount.¹ This method of selling securities had previously been banned by federal securities law. The CROWDFUND Act, enacted in 2012, overturns that prohibition.²

Securities crowdfunding is a new idea, modeled on the recently introduced and highly successful concept of “reward” crowdfunding, which is practiced on Kickstarter, IndieGoGo, and other websites. In reward crowdfunding, artists and entrepreneurs use the Internet to obtain financing from strangers to produce a creative or consumer product, such as a CD or a wristwatch, and the funders are later compensated with the product itself.³ In securities crowdfunding, by contrast, the participants receive no tangible product, but rather a share of stock, a bond, or some other security issued by the company. Part I.A below defines securities crowdfunding and identifies its precursors.

The primary goal of the CROWDFUND Act, described in detail in Part I.B, is to let startup companies and small businesses use the Internet to obtain modest amounts of capital, in much the same manner as reward crowdfunding.⁴ In this it will likely succeed, primarily because the costs associated with crowdfunding securities will be so much lower than costs in a traditional IPO, as explained in Part II.A.

1 The Capital Raising Online While Deterring Fraud and Unethical Non-Disclosures Act (CROWDFUND Act) is one component of the broader Jumpstart our Business Startups (JOBS) Act. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106 §§ 301-05 (codified in 15 U.S.C.).

2 *Id.* at §§ 302(a) (“SECURITIES ACT OF 1933.—Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended by adding at the end the following: “(6) transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that— ‘(A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than \$1,000,000”).

3 See STEVEN JOHNSON, *FUTURE PERFECT* 35 (2012); C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 16-17 (2012) (describing Kickstarter and IndieGoGo, the “leading reward/pre-purchase crowdfunding sites”).

4 See, e.g., Jumpstart Our Business Startups Act, Pub. L. No. 112-106 § 1 (metaphorically indicating that the purpose of the Act is to help startup companies who have stalled to get into gear and on the road to success).

But the Act also has a second goal that may be just as important. Part II.B explores how the crowdfunding of securities will help democratize the market for financing startup companies and small businesses and allow investors of modest means to make investments that had previously been offered solely to wealthy, so-called “accredited” investors.

Finally, our long experience with public capital markets affords the opportunity to predict how securities crowdfunding will play out in practice. This Article makes two such predictions. First, in Part III.A, it predicts that companies that sell equity via crowdfunding may find themselves the subject of hostile takeovers, although founders can easily avoid that outcome if they act with a little foresight. Second, in Part III.B, it predicts that issuers may prefer to crowdfund debt securities, such as bonds, rather than equity, in part because debt better protects founders from potential personal liability. The Article concludes with a few words of advice for the SEC in implementing the Act in light of the risk of fraud.

I. CROWDFUNDING SECURITIES

A. *Crowdfunding and its Precursors*

The concept of crowdfunding has its origins in “crowdsourcing,” which is “a type of participative online activity in which an individual, an institution, a non-profit organization, or company proposes to a group of individuals . . . via a flexible open call, the voluntary undertaking of a task.”⁵ Well known crowdsourced projects include Wikipedia, an online encyclopedia drafted and edited by millions of volunteers,⁶ and Yelp!, a geographically based website comprised of user-drafted reviews of restaurants and shops.⁷

Crowdfunding differs from crowdsourcing in that the crowd is asked to contribute capital, as opposed to labor, to the project. The funding participants, in return, receive the fruits of the project, such as a music CD or a consumer product.⁸ This type of crowdfunding is called “reward” crowdfunding. An author with an idea for a manuscript, for instance, might offer 500 signed copies of the final book to those that pledge \$100, thereby raising \$50,000 to support herself

5 Enrique Estellés-Arolas & Fernando González-Ladrón-de-Guevara, *Towards an Integrated Crowdsourcing Definition*, 38 J. INFO. Sci. 189, 197 (2012).

6 See *Wikipedia*, WIKIPEDIA, <http://en.wikipedia.org/wiki/Wikipedia> (last visited Nov. 24, 2012) (explaining the purpose of Wikipedia).

7 See *What is Yelp?*, YELP, http://www.yelp.com/faq#what_is_yelp (last visited Nov. 24, 2012) (listing the purpose of Yelp).

8 See JOHNSON, *supra* note 3, at 35–44.

while writing and cover the costs of printing and shipping. Once she completes the book, she ships the copies to the original investors.

Reward crowdfunding has been practiced on websites including Kickstarter and IndieGoGo since about 2009, and its popularity and success has been phenomenal, growing into a \$1.5 billion market in just a couple of years.⁹

Securities crowdfunding is a new idea that takes the concept one step further.¹⁰ Rather than receive a copy of the author's to-be-written book, the funding participants receive a share in the profits of the book, or some other security, such as a bond or preferred share, in the book. This was previously banned, or effectively so, by federal securities regulations. The CROWDFUND Act, however, creates a new exemption to those regulations, thereby blessing this novel method for entrepreneurs and investors to find one another on the Internet.¹¹

B. *The CROWDFUND Act*

The federal CROWDFUND Act, signed into law in April 2012, provides a new means for companies to raise capital from investors by establishing an exemption to the Securities Act of 1933 for crowdfunded securities.¹² This is a major change in securities regulation. It opens up new opportunities for entrepreneurs, who will now have the ability to raise capital from investors without having to comply with the costly federal registration requirements, as well as for

9 *Id.*

10 Securities crowdfunding is indeed a new concept, though it was foreshadowed by what this author has called "consumer contract exchanges" in previous work. Andrew A. Schwartz, *Consumer Contract Exchanges and the Problem of Adhesion*, 28 YALE J. ON REG. 313, 359 (2011) ("Theoretically, a peer-to-peer angel exchange for standardized business loans for hundreds of thousands, or even millions, of dollars, could be organized on the Internet. This would have the positive effect of democratizing entrepreneurship by allowing those who lack access to wealthy investors to have a more equal chance of obtaining sufficient funding for their fledgling business. Unfortunately, no such exchange exists at present.").

11 See *supra* note 2. Crowdfunding is not universally available, and is an option only for private domestic companies. Investment companies, foreign private companies, and public companies (whether domestic or foreign) cannot take advantage of the crowdfunding exemption. See 15 U.S.C.A. § 77d-1(f)(1) (West, Sept. 2012 Supp.).

12 Jumpstart Our Business Startups Act, Pub. L. No. 112-106 §§ 301-05 (codified in 15 U.S.C.).

investors of modest means, who now have the ability to invest over the Internet in strangers' startup companies.¹³

1. New Exemption

The Securities Act has long exempted from its registration requirement securities sold to the founder's friends and relations, or unrelated wealthy investors.¹⁴ Hence, financing for fledgling firms is generally obtained from the so-called "three Fs": "family, friends, and fools."¹⁵ This last group includes angel investors, venture capitalists, and the like, though getting such arm's length investors on board is challenging due to the high risk involved in early-stage investing.¹⁶

In sharp contrast to the clubby nature of those traditional exemptions, the idea of crowdfunding is to gather capital from large numbers of people in the "crowd" (*i.e.*, the public), and have each individual provide only a very small amount.¹⁷

2. Limits for Issuers and Investors

The CROWDFUND Act includes monetary limitations for both issuers and investors. Issuers may not raise more than \$1,000,000 annually via crowdfunding.¹⁸ As for investors, the maximum annual aggregate amount of crowdfunded securities that any one investor may purchase is limited based on a sliding scale. If an investor's net worth or annual income is under \$100,000, she can invest the greater of \$2,000, or five percent of her annual income, in crowdfunded securities each year.¹⁹ If her net worth or annual income is over

13 Press Release, President Barack Obama, Remarks at JOBS Act Bill Signing (Apr. 5, 2012), <http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing> ("Right now, you can only turn to a limited group of investors — including banks and wealthy individuals — to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it's time our laws did as well. Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors — namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.").

14 15 U.S.C.A. § 77d(a)(2), (5) (West Sept. 2012 Supp.).

15 Patrick J. Keenan & Christiana Ochoa, *The Human Rights Potential of Sovereign Wealth Funds*, 40 GEO. J. INT'L L. 1151, 1170 n.82 (2009) (citation omitted).

16 See Andrew A. Schwartz, *Old Enough to Fight, Old Enough to Swipe: A Critique of the Infancy Rule in the Federal Credit CARD Act*, 2011 UTAH L. REV. 407, 430 (2011).

17 See Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881 (2011) (describing the crowdfunding process).

18 15 U.S.C.A. § 77d(a)(6)(A).

19 *Id.* § 77d(a)(6)(B)(i).

\$100,000, she can invest 10% of her annual salary, capped at \$100,000, per year.²⁰

Furthermore, there is no limit on the number of shareholders an issuer can have, as another provision of the Act exempts all crowdfunding investors from being counted in the shareholder caps that are relevant in other areas of securities regulation.²¹

3. Financial Intermediaries

Crowdfunding transactions cannot be consummated directly between issuer and investor, but rather must be executed via a financial intermediary registered with the SEC.²² The intermediary can register either as a broker-dealer,²³ or a “funding portal,” which is a new classification of intermediary created by the Act.²⁴ Funding portals will be subject to a new regulatory regime to be established by SEC rulemaking.²⁵

The Act imposes a number of serious obligations on these financial intermediaries. They are required to ensure that each investor reviews investor-education information and positively affirms that they are risking the loss of their entire investment; to ensure that each investor answers a questionnaire demonstrating “[a] an understanding of the level of risk generally applicable to investments startups, . . . [b] an understanding of the risk of illiquidity, and [c] an understanding of such other matters as the [SEC] determines appropriate, by rule;” to take measures to reduce the risk of fraud, including obtaining a background check on the issuer’s officers, directors and substantial investors; and to provide such disclosures as the SEC shall determine, by rule, appropriate.²⁶ The Act also provides a catch-all, requiring intermediaries to “meet such other requirements as the

20 *Id.* § 77d(a)(6)(B)(ii).

21 *Id.* § 78l(g)(6).

22 *Id.* § 77d(a)(6)(C).

23 *See* 15 U.S.C. § 78c(a)(4), (5) (2006) (defining broker and dealer).

24 15 U.S.C.A. § 78c(a)(80).

25 *Id.* § 78c(h)(1). The funding portal is limited to putting buyers and sellers together (*i.e.*, acting as an intermediary), and may not: “(A) offer investment advice or recommendations; (B) solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal; (C) compensate employees, agents, or other persons for such solicitation or based on the sale securities displayed or referenced on its website or portal; (D) hold, manage, possess, or otherwise handle investor funds or securities; or (E) engage in such other activities as the Commission, by rule, determines appropriate.” *Id.* § 78c(a)(80).

26 *Id.* § 77d–1(a)(3)–(5).

[SEC] may, by rule, prescribe, for the protection of investors and in the public interest.”²⁷

The intermediary cannot deliver the proceeds of the offering to the company until the target amount has been reached or exceeded, and must allow investors the opportunity to cancel investment commitments before then.²⁸ The intermediary has the obligation to make sure investors are not exceeding the amount they are allowed to invest under the Act.²⁹ It also must obey a three week waiting period after the SEC and potential investors are provided with required disclosures before commencing trade.³⁰ Finally, directors, officers, or partners of an intermediary may not have any financial interest in an issuer that has listed thereon.³¹

4. Limited Secondary Market

All of this pertains to the primary market, which is the focus of the Act. As for a secondary market, the Act makes almost no reference to such a market. The one exception is that it expressly provides that crowdfunded securities may not be transferred or sold by investors for one year after the date of purchase, unless being transferred to the issuer, an accredited investor, a family member of the purchaser, or as part of an offering registered with the SEC.³²

Moreover, as a practical matter there will be a very small secondary market for any given crowdfunded security. This is simply because the number of shares in the marketplace is likely to be orders of magnitude smaller for a crowdfunded issue than a registered one. Publicly traded companies issue millions or even billions of shares, making it easy to find someone who wants to buy or sell a few.³³ Crowdfunded companies, by contrast, are likely to have only thousands of securities outstanding, making it difficult and expensive to transact in them. For this reason, no liquid secondary market is likely to develop in crowdfunded securities.

27 *Id.* § 77d-1(a)(12).

28 *Id.* § 77d-1(a)(7).

29 *Id.* § 77d-1(a)(8).

30 *Id.* § 77d-1(a)(6).

31 *Id.* § 77d-1(a)(11).

32 *Id.* § 77d-1(e).

33 Dell Inc., for example, has about two billion shares outstanding. *See* Maxwell Murphy, *Dell Founder Boosts Holdings*, WALL ST. J., Dec. 21, 2010, at B7 (reporting that Dell had 1.93 billion shares outstanding as of 2010).

5. Disclosure Requirements for Issuers

Although the purpose of the Act is to lower the cost of capital for startups by alleviating burdensome disclosure requirements, a crowdfunding business must provide some very basic disclosures to the SEC, designated intermediaries, and potential investors:

(A) the name, legal status, physical address, and website address of the issuer; (B) the names of the directors, . . . officers[, and substantial investors] . . . ; (C) a description of the business of the issuer and the anticipated business plan of the issuer; and (D) a description of the financial condition of the issuer³⁴

The SEC has authority to expand this list.³⁵

The disclosure requirements regarding the financial condition of the business (the fourth requirement above) vary depending on the size of the offering. For offerings of \$100,000 or less, income tax returns for last fiscal year and unaudited financial statements certified as accurate by the principle executive officer are required.³⁶ For offerings of between \$100,000 and \$500,000, financial statements reviewed by an independent public accountant are required.³⁷ And for offerings of between \$500,000 and the maximum of \$1 million, audited financial statements are required.³⁸

Issuers must also provide a description of the purpose and intended use of the proceeds, the target offering amount, the deadline to reach that amount, regular updates regarding the progress of the issuer meeting its target amount, the price of the securities to be offered, and a description of the ownership and capital structure of the issuer.³⁹ Issuers are prohibited from advertising the offering themselves, and any solicitation of the offering must go through the registered funding portal.⁴⁰ Finally, following a crowdfunding round, an issuer must annually file with the SEC, and make available to investors financial statements and a report on the results of operations.⁴¹

³⁴ 15 U.S.C.A. § 77d-1(b)(1).

³⁵ *Id.* § 77d-1(b)(1)(I) (requiring that issuers disclose any “other information as the [SEC] may, by rule, prescribe, for the protection of investors and in the public interest”).

³⁶ *Id.* § 77d-1(b)(1)(D)(i)(I)–(II).

³⁷ *Id.* § 77d-1(b)(1)(D)(ii).

³⁸ *Id.* § 77d-1(b)(1)(D)(iii).

³⁹ *Id.* § 77d-1(b)(1)(E)–(H).

⁴⁰ *Id.* § 77d-1(b)(2).

⁴¹ *Id.* § 77d-1(b)(4).

6. Relationship with State Law

The CROWDFUND Act expressly pre-empts state law regarding registration or qualification of securities.⁴² States are not permitted to impose additional regulations upon crowdfunding offerings, issuers, or intermediaries before the securities may be sold.⁴³ That said, states must be provided with notice of crowdfunded offerings.⁴⁴ They also retain the right to bring enforcement actions for fraud or other violations of state securities law not relating to registration.⁴⁵

7. Investor Protection

The disclosure requirements provided for in current securities laws are meant to protect investors from fraud and ensure that information provided by businesses is reliable. Therefore, a possible consequence of the limited disclosure associated with crowdfunding is increased fraud and inaccurate information.⁴⁶

The Act attempts to address this risk in two ways. First, it limits the amount that any given person can invest each year, and thus caps their potential losses.⁴⁷ Second, it expressly authorizes civil actions against an issuer, its directors, and officers.⁴⁸ If any of these parties “makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements . . . not misleading,” they are liable under the Act.⁴⁹

In addition, the SEC is granted “examination, enforcement and other rulemaking authority” over funding portals,⁵⁰ and presumably retains authority to enforce the various statutory and regulatory mandates for both issuers and intermediaries. Finally, the Act recognizes

42 *Id.* § 77r(a).

43 *Id.* § 77r(a)(1)(A), (b)(4)(C).

44 *Id.* § 77d-1(d).

45 *Id.* § 77r(c)(1)(B).

46 Indeed, some commentators see widespread fraud as a probable consequence of securities crowdfunding. *See, e.g.,* Jonathan Weisman, *Final Approval by House Sends Jobs Bill to President for Signature*, N.Y. TIMES, Mar. 27, 2012, at A12 (reporting that crowdfunding “detractors worry that the measure will bring back the ‘boiler rooms’ of the 1990s Internet stock bubble, where hucksters peddle stock tips to unwitting amateur investors. Pension funds, the lobby for older Americans AARP, and the chairwoman of the securities commission had opposed aspects of the bill. [A] spokeswoman for the Council of Institutional Investors, an investor watchdog group, said . . . ‘We may rue the day this bill passed.’”).

47 *See supra* Part I.B.2.

48 15 U.S.C.A. § 77d-1(c)(1)(A), (c)(3).

49 *Id.* § 77d-1(c)(2)(A).

50 *Id.* § 78c(h)(1)(A).

that state authorities retain jurisdiction over issuers or intermediaries that engage in fraud, deceit, or unlawful conduct.⁵¹

II. THE IMPACT OF CROWDFUNDING ON CAPITAL MARKETS

The crowdfunding of securities under the CROWDFUND Act can be expected to have two primary effects on American capital markets. First, crowdfunding will emerge as an important, low-cost method of raising business capital from the public, thus expanding the opportunity for entrepreneurship. Second, crowdfunding will break down the regulatory barrier between accredited and retail investors, at least to some extent, and allow ordinary, non-accredited investors the opportunity to invest in strangers' startups and small businesses.

A. *Low-Cost Source of Capital for Entrepreneurs*

A primary driver behind the CROWDFUND Act is that startup companies are vital to a healthy economy and therefore in the public interest,⁵² yet they consistently have trouble raising the capital they need to thrive.⁵³ Crowdfunding offers a new and attractive means for raising modest amounts of capital that avoids the heavy legal, regulatory, and practical costs of issuing registered securities.

The federal securities laws require that stocks, bonds, or other securities be registered with the SEC before being offered for sale to the public.⁵⁴ This registration process does not entail a substantive review of the business prospects of the issuer of the securities, but it does require that the issuer provide full and clear disclosure of the risks and potential rewards of investing in the securities, and then provide ongoing, regular, and event-based disclosures.⁵⁵ Over time, these

51 *Id.* § 77r(c)(1).

52 *See* Schwartz, *supra* note 16, at 428 (reporting that “start-up firms in their first year have been responsible for all net job creation in the United States since at least the 1970s, having added about three million jobs per year, even during recessions”); Press Release, *supra* note 13 (“America has always had the most daring entrepreneurs in the world. . . . When their ideas take root, we get inventions that can change the way we live. And when their businesses take off, more people become employed because, overall, new businesses account for almost every new job that’s created in America.”).

53 *E.g.*, Angus Loten, *Stalled Crowdfunding Rules Leave Business Plans on Ice*, WALL ST. J., Dec. 13, 2012, at B1 (reporting on entrepreneurs that were denied bank loans and hope to use securities crowdfunding once it goes into effect); Press Release, *supra* note 13 (observing that, “no matter how good their ideas are, if an entrepreneur can’t get a loan from a bank or backing from investors, it’s almost impossible to get their businesses off the ground”).

54 THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 110 (5th ed. 2006).

55 15 U.S.C.A. § 77aa.

initial and ongoing disclosure requirements have become increasingly demanding, thanks to the accumulation of legislative and regulatory barnacles, such as the Sarbanes-Oxley Act of 2002.⁵⁶ Hence today, the process of going public costs millions of dollars in legal, accounting, and other fees and, in a potentially related development, the number of companies electing to do so has shrunk to an all-time low.⁵⁷

The CROWDFUND Act responds to this problem by minimizing the initial and ongoing disclosure requirements for crowdfunding issuers.⁵⁸ By offering starkly lower compliance and promotion costs than a traditional IPO, crowdfunding greatly reduces the cost of raising capital from the public for small entrepreneurs.⁵⁹ For an aspiring restaurateur seeking \$100,000 to open her first place, or an early-stage entrepreneur looking for \$500,000,⁶⁰ a traditional public offering would be way too costly. But crowdfunding can bring down the cost to a point where raising capital from the public is a realistic avenue for such issuers.

There are, to be sure, financing alternatives to a full IPO.⁶¹ SEC Regulation D, for instance, offers a practical way for issuers to raise significant sums at relatively low cost privately, *i.e.*, without going pub-

56 See Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201–66 (2006).

57 See Eric C. Chafee, *Finishing the Race to the Bottom: An Argument for the Harmonization and Centralization of International Securities Law*, 40 SETON HALL L. REV. 1581, 1590 (2010); Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 11–13 (2012);

58 15 U.S.C.A. § 77d-1(b)(1). Recall, however, that the SEC has authority to require additional disclosures from crowdfunding issuers under Jumpstart Our Business Startups Act. *Id.* § 77d-1(b)(1)(I).

59 This is not to say that crowdfunding can reduce the cost of capital itself, a question beyond the scope of this Article. See generally *Testimony of John C. Coates IV, Harvard Law School, Before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, United States Senate, Dec. 14, 2011*, available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg55479/pdf/CHRG-111shrg55479.pdf> [hereinafter *Coates Testimony*] (distinguishing between the cost of capital and the cost of raising capital).

60 See, e.g., Katy McLaughlin, *Breaking into the Pop-up Restaurant Business*, WALL ST. J., Mar. 22, 2012, at B4 (reporting that founders of “Wise Sons Jewish Delicatessen,” coming soon to San Francisco, raised \$100,000 from friends and family and invested a like amount from their own savings); Vanessa O’Connell, *Warby Parker Co-Founder Says Initial Vision Was All About Price*, WALL ST. J., July 19, 2012, at B7 (reporting that online eyewear retailer Warby Parker obtained \$250,000 in early-stage financing).

61 One potential alternative is a simple bank loan. Such loans, however, are very difficult to obtain, especially for early-stage startup companies. Schwartz, *supra* note 16, at 430 & n.159; Loten, *supra* note 53, at B1 (providing anecdotal reports of entrepreneurs that were denied bank financing).

lic.⁶² But thanks to the intricacies of Regulation D and its interaction with state Blue Sky laws, these offerings have been almost always offered solely to accredited investors, on a private basis and with no advertising or other “general solicitation.”⁶³

The upshot is that if an entrepreneur lacks wealthy connections or is otherwise “out of the loop,” she may find Regulation D unsuited to her needs. For a wide public solicitation of securities, registration is generally required.⁶⁴ Hence, the remainder of this section focuses on public offerings and contrasts the high cost of a registered offering with the expected low cost of crowdfunding securities.

1. The High Cost of a Registered Offering

There are two primary drivers of the high cost of a registered public offering. First, there is the cost of compliance with the extensive securities laws and regulations. Second, there is the cost of promoting the offering. The result is that a registered public offering is just too expensive for all but the largest issuers.⁶⁵

a. Compliance Costs

An ordinary sale of securities to the public implicates the 1933 Securities Act’s registration provisions,⁶⁶ which requires the filing of a registration statement including thirty-two separate pieces of informa-

62 17 C.F.R. §§ 230.500-508 (2012); *see, e.g.*, VLAD IVANOV & SCOTT BAUGUESS, CAPITAL RAISING IN THE U.S.: THE SIGNIFICANCE OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, at 3 (2012), *available at* http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf (reporting that “capital raised through Reg D offerings is more than twice as large as public equity offerings”); Rutheford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC’s Crown Jewel Exemptions*, 66 BUS. LAW. 919, 924–26 (2011) (describing the origin and structure of Regulation D).

63 Ivanov & Bauguess, *supra* note 62, at 2; Campbell, *supra* note 62, at 926, 932–33.

64 It bears noting that another portion of the JOBS Act directs the SEC to do away with the ban on general solicitation and advertising for offerings under Rule 506 of Regulation D. Jumpstart Our Business Startups Act, Pub. L. No. 112-106 § 201(a)(1). The limitation to accredited investors remains, however. *Id.* (“provided that all purchasers of the securities are accredited investors”). Furthermore, political hostility to this change remains potent, creating uncertainty as to when and how it will be put into practice. *See* Jean Eaglesham and Telis Demos, *SEC Chief Delayed Rule Over Legacy Concerns*, WALL ST. J., Dec. 3, 2012, at C1 (reporting that the termination of the general solicitation ban is “one of the most contentious changes in the JOBS Act”).

65 *See* Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC’s Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 1, 10 (2007).

66 *See* HAZEN, *supra* note 54, at 110.

tion, many of which require extensive and careful drafting.⁶⁷ The registration statement must include information about the company issuing the securities, the securities being offered, and the method of distribution of the securities—all in exquisite detail.⁶⁸ For example, a registered issuer must describe and include copies of recent and upcoming material contracts not made in the ordinary course of business, including all bonus and profit-sharing agreements.⁶⁹

Preparation of a registration statement can require over 1,200 hours of work,⁷⁰ demanding the cooperation of, “among others, the issuer, the issuer’s attorneys (both inside house counsel and outside general counsel), the underwriter, the underwriter’s attorneys, and the accountants who serve as auditors for the financial statements.”⁷¹

Additionally, following the SEC’s approval of the registration statement, the company must comply with ongoing reporting requirements of the Securities Exchange Act of 1934.⁷² The burdens of the Securities Exchange Act were dramatically increased by the passage of the Sarbanes-Oxley Act, which imposed heightened periodic disclosure requirements and accounting and auditing reforms, resulting in substantially higher compliance costs,⁷³ not to mention the cost of distracted executives.⁷⁴

67 15 U.S.C.A. § 77aa.

68 ALLAN B. AFTERMAN, SEC REGULATION OF PUBLIC COMPANIES 19 (1995); JAMES D. COX ET. AL., SECURITIES REGULATION: CASES AND MATERIALS 145–48 (5th ed. 2006) (statement must include “in-depth explanations of the industry in which the issuer operates, the services or products the company provides, the risk factors associated with the issuer’s industry and operations, the intended use of the money received in the offering, information about officers, directors and principal shareholders, and audited financial statements for current and prior years”).

69 15 U.S.C.A. § 77aa(24), (30).

70 C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 25 (2001); see also, RICHARD A. BOOTH, CORPORATIONS, FINANCING THE CORPORATION § 7.3 (2011) (citing an SEC estimate of “1176 hours to complete Form S-1”).

71 HAZEN, *supra* note 58, at 110.

72 15 U.S.C.A. § 78o(d).

73 BOOTH, *supra* note 70, at § 3.1 (6th ed. Supp. 2012) (estimating that by 2007 the cost of SEC compliance for a 1934 Act reporting company with less than one billion dollars in revenue had increased to \$2.8m per year as compared to the average \$1.1m in SEC compliance costs prior to the adoption of the Sarbanes–Oxley Act amendments in 2002); THOMAS E. HARTMAN, FOLEY & LAUDNER LLP, THE COST OF BEING PUBLIC IN THE ERA OF SARBANES-OXLEY 16 (2006) (“[S]ince the enactment of the Sarbanes-Oxley Act, the average cost of compliance for companies with under \$1 billion in annual revenue has increased . . . to approximately \$2.8 million.”); HAZEN, *supra* note 54, at 114.

74 See BOOTH, *supra* note 70, § 7.3 (“It has also been estimated that an IPO consumes 40% of CEO time and 75% of CFO time during the registration process.”);

In short, going public has become non-viable for smaller businesses due to the onerous registration requirements and regulatory burdens accompanying a public securities offering.⁷⁵ Registration costs are disproportionately burdensome on small offerings, because they are relatively insensitive to the size of the offering.⁷⁶

b. Promotion Costs

The promotion of a public offering is traditionally accomplished in a carefully choreographed procedure called a “road show.”⁷⁷ The road show is not a legal requirement, but is a practical one, given the norms of the major banks that orchestrate IPOs.⁷⁸ This is an expensive endeavor that calls for public relations, catering, travel, printing, and many other types of specialists, each of whom command premium fees.⁷⁹ This aspect of the registered offering is not only expensive, it also greatly distracts executives from their primary task of running the business.

2. The Low Cost of Crowdfunding

Selling crowdfunded securities will almost certainly be much less expensive than going through a registered offering. This is primarily because they are exempt from the registration requirement and its attendant costs. Another important factor is the lower cost of promoting a crowdfunded issue via the Internet as opposed to an in-person road show.

a. Compliance Costs

The CROWDFUND Act provides an exemption to the federal securities registration requirement, meaning securities offered via

William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of “Going Private,”* 55 EMORY L.J. 141, 147 (2006).

75 See Cohn & Yadley, *supra* note 65, at 7–8.

76 See Bradford, *supra* note 70, at 24 (“The cost to prepare a registration statement, including audited financial statements, is essentially the same whether the company is selling \$500 or \$500 million dollars of securities.”); *id.* at 4 (“The high cost of Securities Act registration makes a registered public offering ‘impractical for most small business issuers.’”); Cohn & Yadley, *supra* note 65, at 6.

77 Cohn & Yadley, *supra* note 65, at 9.

78 Even Facebook and its iconoclastic CEO, Mark Zuckerberg, followed tradition and conducted a road show in connection with the company’s IPO. Ryan Dezember, et al., *When Facebook Met Wall Street*, WALL ST. J., May 8, 2012 at B1.

79 See, e.g., *id.* (describing road show that consisted of presentation over lunch at Manhattan hotel for more than 500 investors and analysts, to be followed by similar events in Boston and Palo Alto).

crowdfunding need not comply with the registration provisions of the Securities Act of 1933.⁸⁰ Therefore, no registration statement need be filed prior to the sale of securities via crowdfunding, eliminating the attorney costs, underwriting costs, printing costs, and accounting costs associated with the preparation of a registration statement.⁸¹

Additionally, because crowdfunded securities are not registered under the '33 Act, the issuer of those securities need not comply with the ongoing (and costly) reporting requirements set forth in the Securities Exchange Act of 1934.⁸² Therefore, the issuer avoids costly quarterly and annual reporting obligations, as well as the major costs associated with Sarbanes-Oxley compliance.⁸³ Finally, by exempting funding portals from the Securities Exchange Act's registration obligations on broker-dealers,⁸⁴ they will likely be subject to a less burdensome regulatory scheme, resulting in lower costs for the funding portals that will likely be at least partly reflected in the price issuers have to pay to use their services.

b. Promotion Costs

Crowdfunding will take place entirely over the Internet.⁸⁵ As such, the cost of promoting an offering will be much lower than a traditional road show, which entails a number of in-person meetings and presentations. And online crowdfunding campaigns can easily reach many more potential investors than would be possible in the traditional format. Facebook "campaigns," for instance, have proved to be a very low-cost means of quickly rallying large numbers of people behind a cause, whether it is political liberation, as in the case of the "Arab Spring,"⁸⁶ or less important issues, such as which Wal-Mart is

80 15 U.S.C.A. § 77d(a)(6) (West Supp. 2012).

81 See Cox, *supra* note 68, at 149.

82 15 U.S.C. § 78m(a) (requiring ongoing reports from issuers of securities registered under the 1933 Act). See generally William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 644 (2009) ("Annual reports must include a description of the company's business, risk factors, audited financial statements for the year, MD&A, and information concerning executive compensation. Quarterly reports must include unaudited quarterly financial statements and MD&A with respect to quarterly results." (citations omitted)).

83 See *supra* note 73.

84 15 U.S.C.A. § 78c(h)(1).

85 CROWDFUND stands for Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure.

86 See Schwartz, *supra* note 16, at 422.

the best.⁸⁷ There is every reason to believe that crowdfunding issuers and intermediaries can and will use Facebook or other types of social media to promote their offerings to a wide audience at low cost.

3. Some Compliance Burdens Remain

Many of the high costs accompanying a registered sale of securities are avoided by the crowdfunding exemption, but the CROWDFUND Act still imposes several disclosure requirements on a business conducting a crowdfund offering. The issuer must file with the SEC, and make available to the relevant funding portal and potential investors, a sizeable disclosure document consisting of information about the business, its financial situation, and the offering.⁸⁸ Regarding information about the business's financial situation, for offers of over \$500,000, audited financial statements are required.⁸⁹ What is more, the SEC has the power to ramp this up by promulgating additional disclosure requirements.⁹⁰

Similarly, although an issuer selling securities via a crowdfunding offering need not comply with the reporting obligations mandated by the Securities Exchange Act, the CROWDFUND Act creates its own set of reporting obligations. For example, following a crowdfunding offering, the issuer must "file with the [SEC] and provide to investors [annual] reports of the results of operations and financial statements of the issuer"⁹¹ In addition to those filings, the SEC is given the power to promulgate additional requirements.⁹²

In addition, although funding portals are exempt from registration as broker-dealers and the regulation that accompanies such registration, the CROWDFUND Act directs the SEC to create a separate regulatory scheme for funding portals.⁹³ The Act, which subjects

87 *Writer's Facebook Caper Sends Pitbull to Kodiak's Walmart*, ANCHORAGE DAILY NEWS, July 17, 2012, <http://www.adn.com/2012/07/17/2545935/writers-facebook-caper-sends-pitbull.html>.

88 15 U.S.C.A. § 77d-1(b)(1) (West Supp. 2012).

89 *Id.* § 77d-1(b)(1)(D)(iii).

90 *Id.* § 77d-1(b)(1)(I) (requiring issuers to "file . . . and provide . . . such other information as the [SEC] may, by rule, prescribe, for the protection of investors and in the public interest").

91 *Id.* § 77d-1(b)(4).

92 *Id.* § 77d-1(b)(5).

93 *Id.* § 78c(h)(1)(A), (C); see *An Authoritative Look at the New Crowdfunding Legislation*, FUNDINGLAUNCHPAD (Apr. 3, 2012), <http://blog.fundinglaunchpad.com/2012/04/investment-crowdfunding-legislation-review/> (predicting that SEC regulation of funding portals will be substantial).

intermediaries to any requirements the SEC determines appropriate,⁹⁴ also sets numerous other requirements on them.⁹⁵

Finally, the CROWDFUND Act excuses issuers from the registration requirements of federal and state securities laws, but not their anti-fraud requirements.⁹⁶ So, for example, an issuer could still be liable for fraud if it makes untrue (or misleadingly incomplete) statements in connection with the sale of its crowdfunded securities.

4. Conclusion

In sum, the crowdfunding of securities stands a good chance of lowering the cost of raising relatively small amounts of business capital from the disparate public, thus giving entrepreneurs a new avenue for fund raising.

In addition, crowdfunding can also be expected to have the effect of democratizing entrepreneurship, because, as will be seen in the next section, startup businesses have for the past several decades been financed by angel investors, venture capitalists, and other wealthy and connected people. Someone with no personal connection with such people, however, would have an especially difficult time finding capital for her business. By allowing entrepreneurs to seek financing via the Internet, however, crowdfunding enhances the possibility that an aspiring entrepreneur from a modest background and/or geographically remote region (for example, far from Silicon Valley) would find financial backers for her vision.⁹⁷

B. New Opportunity for Retail Investors

Prior to the passage of the CROWDFUND Act, the chance to invest in a startup company was generally made available only to wealthy investors and friends of the founders. This was an artifact of two exemptions embedded in federal securities law for certain types of non-public offerings.

First, the federal securities laws have always exempted so-called “private offerings” from the registration requirement.⁹⁸ Second, there is a longstanding exemption for securities offerings made only to wealthy investors that are “accredited” by the SEC to make such invest-

94 15 U.S.C.A. § 78c(h)(1)(C).

95 *Id.* § 77d-1(a).

96 *Id.* § 77r(c)(1)(B).

97 *Cf.* John Elignon, *Tech Start-Ups Find a Home on the Prairie*, N.Y. TIMES, Nov. 22, 2012, at A1 (reporting that capital for start-ups “remains relatively sparse” in the Great Plains region, in part because most venture capital firms are located on the coasts).

98 *See id.* § 77d(a)(2) (exempting non-public offerings).

ments.⁹⁹ This latter exemption dates back to an SEC regulation adopted in 1982, which clarified that wealthy people—those with a net worth of more than \$1 million—were deemed to be “accredited.”¹⁰⁰

Recall that because securities registration is an onerous and expensive process, companies often prefer to raise capital in ways that will avoid the registration requirement.¹⁰¹ The practical effect is that entrepreneurs commonly avoid public offerings and offer unregistered securities of their startup companies only to people that come within either the private offering exemption (that is, family and friends) or the accredited investor exemption (that is, the wealthy).¹⁰² Non-millionaires have been left out, effectively barred from investing in strangers’ startup companies, thanks to this regulatory apparatus.

Consider Facebook, Inc.: For the first seven years of Facebook’s existence (2004–12), only friends, family, and wealthy (“accredited”) investors were offered or allowed to buy stock in the company.¹⁰³ People of modest means (and who did not happen to know Mark Zuckerberg) were prohibited from investing in Facebook.

The public was finally allowed to buy shares in Facebook when the company staged its “initial public offering” (IPO) earlier this year, but by that point the early speculative returns may have been exhausted. Early investors that put in hundreds of thousands of dollars saw their investment grow to be worth billions.¹⁰⁴ By contrast, the

99 *Id.* § 77d(a)(5).

100 *See* 17 C.F.R. §§ 230.501(a)(5), .215(f) (2012).

101 Of course, the high cost of a public offering may well be worth it, as the highly regarded securities laws and enforcement regime in the United States are widely viewed as lowering the cost of capital, even as they raise the cost of raising that capital. *See, e.g., Coates Testimony*, *supra* note 59.

102 President Barack Obama remarked at the JOBS Act Bill signing on April 5, 2012 that: “Right now, you can only turn to a limited group of investors—including banks and wealthy individuals—to get funding. Laws that are nearly eight decades old make it impossible for others to invest.” Doug Rand, *The Promise of Crowdfunding for Social Enterprise*, OFFICE OF SOCIAL INNOVATION AND CIVIC PARTICIPATION (June 28, 2012, 6:15 PM), <http://www.whitehouse.gov/blog/2012/06/28/promise-crowdfunding-social-enterprise> (quoting President Obama’s remarks).

103 *See, e.g.,* Tally M. Wiener & Nicholas B. Malito, *On the Nature of the Transferred Bankruptcy Claim*, 12 U. PA. J. BUS. L. 35, 39 n.20 (2009) (reporting that “SecondMarket,” an online marketplace where Facebook shares were traded before it went public (from 2008–12), only allowed accredited investors to participate).

104 Brian Womack & Ari Levy, *Facebook Director Stock Sales Top \$1 Billion as Lock-Up Ends*, BLOOMBERG (Aug. 21, 2012), <http://www.bloomberg.com/news/2012-08-20/facebook-director-thiel-sold-20-1-million-shares-after-lock-up.html> (reporting that billionaire Peter Thiel invested \$500,000 in Facebook in 2004 and sold most of his stake shortly after the public offering for more than \$1 billion). To be fair, the press likely

IPO was sold to the public in May 2012 at \$38 per share; the stock dropped below \$30 within days, and it soon dipped below \$20.¹⁰⁵ In other words, the earliest private investors earned several thousand times their money, while the earliest public investors are sitting on huge losses.¹⁰⁶

The CROWDFUND Act will, to some extent, break down this barrier between accredited and retail investors. It will allow ordinary non-accredited investors to take a chance and invest in the unregistered securities of a stranger's startup.¹⁰⁷ Many startup companies fail, and many crowdfunded companies will surely suffer that fate. Returns may be much worse than in the stock market or elsewhere, but it seems only fair to give everyone, not only the wealthy and connected, the freedom to take their chances and invest in what they hope will be the next Facebook or Yelp.¹⁰⁸

Furthermore, retail investors are likely to take advantage of this opportunity. A primary piece of evidence for this prediction is the securities laws themselves. A driving theory of the federal Securities Act and its extensive progeny, as well as state Blue Sky laws, is that mom-and-pop investors will gladly invest in risky business ventures if allowed to do so. Those laws, including the registration requirement, were designed to throw up a barricade between untested startup companies and retail investors. The CROWDFUND Act drills a hole in that wall and there is every reason to expect that American investors will act just as they always have and buy into the prospect that this or that company is their ticket to riches.¹⁰⁹

does not learn of, let alone widely report, the losses that early Facebook investors, including Thiel, may have experienced in other ventures.

105 Kaitlyn Kiernan & Jonathan Cheng, *Investors Bet on Facebook Fall*, WALL ST. J., May 30, 2012, at A1. As of October 19, 2012, Facebook was trading on the Nasdaq at \$18.90. It has since recovered to some extent, and traded at \$27.98 on December 11, 2012.

106 Jonathan Cheng, *For Many Financial Advisers, Stocks Become a Hard Sell*, WALL ST. J., Dec. 11, 2012, at A1 (describing retail investors' interest in the Facebook IPO and subsequent discontent).

107 They already have the opportunity to gamble unlimited amounts in Las Vegas or via state lotteries.

108 Note, however, that companies like these that grow over the course of several years into billion-dollar enterprises almost certainly need to issue much more than \$1 million in securities per year, which is the statutory cap for crowdfunding.

109 The amount of capital such retail investors actually have to invest on speculative ventures is an open question. Cf. Cheng, *supra* note 106, at A1 (reporting that only 53% of Americans owned stocks in any form, including in mutual funds and 401(k) retirement accounts; this figure is "down from 65% in a 2007 poll and is the lowest since 1998," when polling began).

Moreover, a hint of the enthusiasm that investors may show for crowdfunding securities has already been seen on reward crowdfunding websites like Kickstarter.¹¹⁰ For example, a “smart watch” start-up company called Pebble Technology recently raised over \$10 million on Kickstarter by essentially selling in advance the watches it will produce, at a cost of about \$100 each.¹¹¹ The immense and growing popularity of reward crowdfunding provides ground for optimism regarding the prospects that retail investors will embrace the opportunity that the CROWDFUND Act provides.¹¹²

In conclusion, there is good reason to expect that the crowdfunding of securities will open up a new chapter in the financing of startup companies, one in which all investors, wealthy or not, have a chance to invest in such speculative assets.

III. CROWDFUNDING IN THE CRYSTAL BALL

This last Part offers two predictions as to how the crowdfunding of securities is likely to work in practice: First, an active market for corporate control may develop. Second, crowdfunding entrepreneurs may prefer to sell debt, rather than equity, to the public.

A. *An Active Market for Corporate Control May Develop*

The “market for corporate control”¹¹³ implies that if a company is poorly or inefficiently managed, “control shifts from less capable managers to others who can manage corporate assets more profitably.”¹¹⁴ The two ways in which control can be shifted are proxy contests and the direct purchase of shares, generally through a tender offer.¹¹⁵ In the crowdfunding context, both of these methods will become more powerful than they have been with regard to traditional registered

110 See generally STEVEN JOHNSON, *FUTURE PERFECT* 35–44 (2012).

111 Pui-Wing Tam, *Pebble Technology Becomes Kickstarter Test Case*, WALL ST. J., July 2, 2012, at B1; *Pebble: E-Paper Watch for iPhone and Android*, KICKSTARTER.COM (Apr. 11, 2012), <http://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android>.

112 As of July 2010, promoters on Kickstarter had raised a total of \$15 million for 1,600 projects. Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS: TENN. J. BUS. L. 63, 73 (2011). Two years later, the total is \$409 million for nearly 77,022 projects. *Kickstarter Stats*, KICKSTARTER, <http://www.kickstarter.com/help/stats> (last visited on Nov. 25, 2012).

113 Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965).

114 Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 5 (1978).

115 *Id.*

securities.¹¹⁶ Proxy fights over crowdfunded issuers will likely be much more affordable than in the traditional context, and tender offerors will apparently be free to engage in coercive tactics that would be unlawful were they attempted with registered securities.

1. Crowdfunded Issuers are a Fertile Ground for Hostile Takeovers

a. Proxy Contests

The holder of a share of stock is generally provided the right to vote in corporate elections.¹¹⁷ A proxy contest is when an insurgent slate of directors attempts to replace the incumbent board of directors by persuading a majority of shareholders to vote for the insurgents rather than for the incumbent directors.¹¹⁸

In the traditional corporate context, proxy contests are generally viewed as “an inferior means of effecting corporate control changes.”¹¹⁹ Shareholders of publicly held corporations are rationally apathetic and widely dispersed, so coordinating them to vote for an insurgent slate is difficult.¹²⁰ Serious proxy contests entail mass mailings and advertisements, as well as litigation or the threat thereof, and are therefore rather expensive.¹²¹ They also require strict compliance with the extensive federal regulations governing proxy contests,¹²² which entails additional costs. Shareholders are seldom willing to incur all of these costs, because they will not be reimbursed if they lose,¹²³ which is the most likely outcome.¹²⁴

116 This effect may be muted, however, to the extent that issuers crowdfund debt, as opposed to equity, because debt holders lack the right to vote for directors and therefore are not involved in a proxy contest or tender offer. It therefore bears noting that this Article predicts that debt may be the security of choice by crowdfunding issuers. See *infra* Part III.B.

117 JAMES D. COX & THOMAS LEE HAZEN, 2 TREATISE ON THE LAW OF CORPORATIONS § 13:1 (2011); Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1261 (2009).

118 Mark A. Stach, *An Overview of Legal and Tactical Considerations in Proxy Contests: The Primary Means of Effecting Fundamental Corporate Change in the 1990s*, 13 GEO. MASON L. REV. 745, 746 (1991).

119 Stephen Mahle, *Proxy Contests, Agency Costs, and Third Generation State Antitakeover Statutes*, 15 J. CORP. L. 721, 734 (1990).

120 Benjamin I. Sachs, *Unions, Corporations, and Political Opt-Out Rights After Citizens United*, 112 COLUM. L. REV. 800, 855 (2012) (“[S]hareholders are generally defined by their wide dispersal from one another and by their rational apathy toward the corporation’s decisionmaking.”); Mahle, *supra* note 119, at 734.

121 Stach, *supra* note 118, at 776–77.

122 See 17 C.F.R. §§ 240.14a-1–14a-104 (2006).

123 Stach, *supra* note 118, at 777.

In the crowdfunding context, by contrast, proxy fights may be sufficiently affordable and likely to succeed to make them worthwhile.¹²⁵ The difficulty of shareholder coordination could potentially be alleviated by virtue of increased use of the Internet.¹²⁶ Even in the traditional context, shareholders are already using message boards to coordinate proxy contests, and “some are creating internet websites solely for the purpose of challenging management at particular companies.”¹²⁷

This nascent trend can be expected to go nuclear when it comes to crowdfunded securities: Crowdfunding will take place entirely online, so the investor base will be experienced with the Internet and particularly well suited to coordinate with one another via such means. Just as in the promotion context, online “campaigns” can spread the word and rally support very quickly and at very low cost.¹²⁸ Proxy contests would seem to be amenable to Facebook, Twitter, or other types of online campaigns. This should bring down the price and raise the chances of success of proxy contests over crowdfunded issuers vis-à-vis their registered brethren.

Furthermore, many of the proxy regulations are avoided in crowdfund-shareholder proxy contests. Federal proxy regulations only apply to registered securities.¹²⁹ Because crowdfunded securities are not registered,¹³⁰ a proxy contest involving the holders of crowdfunded securities need not comply with the complex proxy rules contained in SEC Regulation 14A.¹³¹ Such a contest would also avoid, of course, the costs associated with compliance with those rules.¹³²

The increased likelihood of success resulting from Internet-facilitated communication, combined with the lower compliance costs

124 Thomas J. André, Jr., *A Preliminary Inquiry into the Utility of Vote Buying in the Market for Corporate Control*, 63 S. CAL. L. REV. 533, 579 (1990).

125 This is so even though the value of the companies at stake may be quite small, because the cost of an online proxy fight might be so very low as to make it economical.

126 Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW 23, 31–32 (2004) (“[T]he Internet . . . has greatly enhanced the ability of shareholders to communicate . . . with each other, and with management, at little cost.”).

127 Broc Romanek & Mark S. Britton, *Online Shareholder Activism: How to Guard Against Its Fallout*, 20 No. 5 ACCA DOCKET 33, 34 (2002).

128 See *supra* text accompanying notes 85–87.

129 15 U.S.C. § 78n(a) (2006).

130 See *supra* Part II.A.

131 17 C.F.R. §§ 240.14a-1–14a-104 (2011).

132 See generally Stach, *supra* note 118 (outlining the context and tactics of proxy contests).

faced with respect to crowdfund-shareholder proxy contests, may likely prompt increased use of proxy contests as a means of ousting incumbent management.

b. Tender Offers

A shift in control can also be effectuated by the direct purchase of shares, generally in the form of a tender offer.¹³³ A tender offer is when a potential acquirer seeks to buy up a majority of the corporation's stock from its current shareholders all at once.¹³⁴ If successful, the buyer becomes the majority shareholder and gains control of the company, allowing her to install a new board of directors, remove the existing managers, and install new ones of her choosing.¹³⁵

Decades ago, tender offers were viewed simply as market transactions between willing participants and were not regulated by federal securities law.¹³⁶ Over time, however, "corporate raiders" developed coercive techniques to accomplish unfair tender offers.¹³⁷ Some of the classic maneuvers of this era include the "Saturday Night Special" and the front-loaded two-tier tender offer. A Saturday Night Special is a tender offer that is kept open only for a short time and made available only to the first shareholders who tender, in order to create pressure on shareholders to rush to tender, at perhaps less than the best price they could have achieved had they had more time.¹³⁸ A front-loaded two-tier tender offer is one in which the consideration paid in the first step is greater than that paid in the second step, forcing shareholders to tender quickly or face the risk that they will receive the aptly named "back end."¹³⁹

133 Fischel, *supra* note 114, at 5.

134 Jordan M. Barry & John William Hatfield, *Pills and Partisans: Understanding Takeover Defenses*, 160 U. PA. L. REV. 633, 639 (2012).

135 *Id.* at 639–40.

136 See John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1752–53 (2007).

137 See *id.* at 1753.

138 See, e.g., *id.* at 1734 (describing "so-called 'Saturday night special' bids that are kept open only for a short time and made available only to the first shareholders who tender in order to create pressure on shareholders to rush to tender").

139 *Front-End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique*, 131 U. PA. L. REV. 389, 397 (1982) (describing front-loaded, two-tiered offers in which the consideration paid in the first step is greater than that paid in the second step, forcing shareholders to tender quickly or face the risk that they will be frozen out); see *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985) ("It is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier,

Eventually the federal government decided to legislate, beginning with the Williams Act of 1968.¹⁴⁰ This Act, combined with subsequent federal statutes and regulations, has effectively banned the Saturday Night Special, the front-loaded two-tier tender offer, and other devices viewed as coercive.¹⁴¹

But these prohibitions apply only to tender offers for registered securities.¹⁴² Hence coercive takeover maneuvers that are expressly banned by federal law may be perfectly legal for unregistered crowdfunded securities.¹⁴³ Issuers of crowdfunded securities may well be forced to combat coercive hostile takeovers from acquirers taking advantage of this exemption from the Williams Act.

It must be noted that while a secondary market is obviously a prerequisite to a tender offer, the CROWDFUND Act severely handicaps the ability of a secondary market to develop in crowdfunded securities.¹⁴⁴ Indeed, the Act generally forbids such securities from being alienated for one year after the date of original purchase. There is however an express exception to this rule for sales to accredited investors.¹⁴⁵ And just about every person that is in position to launch a tender offer is likely sufficiently wealthy to qualify as an accredited investor, so the Act's apparent ban on a secondary market is unlikely to hinder tender offers.¹⁴⁶

c. State Anti-Takeover Statutes Remain in Effect

In addition to the federal regulation of hostile takeovers, most states (including Delaware) have enacted one or more "anti-takeover"

even if the price is inadequate, out of fear of what they will receive at the back end of the transaction.").

140 The Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. § 78n(d)-(f) (1982) and as amended at 15 U.S.C. § 78m(d)-(e) (1982 & Supp. V 1987)) (adding Sections 14(d)-(f) and 13(d)-(e) to the Exchange Act).

141 Dale A. Oesterle, *The Rise and Fall of Street Sweep Takeovers*, 1989 DUKE L.J. 202, 217-18 (1989) (describing the Williams Act's prescription for "a twenty-day minimum offering period, shareholder withdrawal rights coextensive with the offering period, withdrawal rights after sixty days from the initial offer if the offeror has failed to pay, pro rata acceptance for over-subscribed offers, nondiscrimination among offerees, and the extension of any price increase during the tender offer to all shareholders who have already tendered" (footnotes omitted)).

142 15 U.S.C. § 78n(d)(1) (2006).

143 State law might speak to the issue.

144 See *supra* Part I.B.1.

145 15 U.S.C.A. § 77d-1(e) (West Supp. 2012).

146 It is possible, of course, that the SEC will issue regulations for crowdfunded securities that mirror the Williams Act's ban on coercive tender offers. To date, however, this issue does not appear to have captured its attention.

statutes designed to impede the transfer of corporate control away from an incumbent board.¹⁴⁷ These statutes are generally not limited to those with federally registered securities, and therefore will act to protect founders and incumbent boards of crowdfunding issuers from hostile takeovers.¹⁴⁸ Still, the protection they offer, especially in states like Delaware, will not provide a great deal of protection in the absence of federal takeover regulation.¹⁴⁹

d. Founders Can Insulate Themselves from the Market for Corporate Control

As described in the previous subsection, the market for corporate control for crowdfunding issuers is relatively unfettered compared with registered issuers. This might mean that companies that sell shares through crowdfunding will regularly be the subject of hostile takeovers.

It is a fairly simple matter, however, for founders and incumbent management teams at crowdfunding issuers to more-or-less insulate themselves from the threat of hostile takeover. One way to accomplish this goal would be for the company to crowdfund only a minority of the voting shares, leaving the founder and her confidants with a majority block.¹⁵⁰ Another method would be for the founder, say, to receive stock with super-voting rights, such as ten or one hundred votes per share.¹⁵¹ Yet a third method would be to crowdfund only non-voting shares.¹⁵² Using any of these techniques, it would be easy

147 See generally, e.g., Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999).

148 The application of many anti-takeover statutes is limited to corporations that either trade on a national securities exchange such as the New York Stock Exchange, or that have a large number of shareholders. See, e.g., DEL. CODE ANN. tit. 8, § 203(b)(4) (West 2007) (applies to corporations with more than two thousand stockholders); IND. CODE ANN. § 23-1-42-4(a)(1) (West 2009) (applies to corporations with one hundred or more shareholders). Nearly all crowdfunding issuers that issue stock can be expected to meet the minimum stockholder requirements, as the basic idea of crowdfunding is to raise capital from a large number of investors.

149 DALE A. OESTERLE, *MERGERS AND ACQUISITIONS IN A NUTSHELL* 273 (2d ed. 2006) (“The Delaware statute, like most state anti-takeover statutes . . . does not present a substantial additional deterrent to hostile takeovers over what firms had created through poison pill plans and other firm-specific defenses.”).

150 See, e.g., *Dodge v. Ford Motor Co.*, 170 N.W. 668, 671 (Mich. 1919) (noting that Henry Ford at that time held 58% of the shares in Ford Motor Co.).

151 See, e.g., Robert Cyran, *Google Rejoins Race to the Bottom*, BUS. TIMES SINGAPORE, Apr. 14, 2012, at A11 (reporting that Google plans to begin issuing non-voting stock).

152 *Id.* (reporting that, thanks to their super-voting shares, Google founders and officers Larry Page, Sergey Brin, and Eric Schmidt “control 66 per cent of the votes with about a quarter of all shares”).

for the founder to retain a majority of the voting power and thus have no fear of a hostile takeover.¹⁵³

In conclusion, we may see a few high-profile hostile takeovers of some of the earliest crowdfunding issuers. After that, the industry will likely react, and founders will, as a matter of routine practice, retain majority-voting power themselves.

B. Debt May Be the Security of Choice to Crowdfund

A hostile takeover is not really a threat unless a majority of the stock is held by the public. But other risks and concerns can arise even if only a minority of the voting shares are issued to strangers—indeed they can arise if a single share of non-voting stock is sold.

Thus it makes sense to consider alternative securities, apart from stock, that may be appropriate to crowdfund. Most discussions of the CROWDFUND Act presume that issuers will sell stock (equity) in their companies via crowdfunding,¹⁵⁴ but the Act permits any “security” to be crowdfunded.

This Part predicts that bonds (or other types of debt instruments) may be the preferred security to crowdfund, rather than stock, primarily because it much better protects the founder from personal liability. Selling even a single share of equity to a stranger creates a real risk that shareholders will sue the founder in her personal capacity.¹⁵⁵ Bonds, notes, and other debt instruments, by contrast, are contractual obligations between the investor and the corporation, meaning that unpaid debt-holders may only sue the corporation—and not the founder herself.¹⁵⁶

153 One venture capital industry contact reports anecdotally that lawyers are indeed advising clients considering crowdfunding to ensure that the founder retains voting control, one way or another.

154 *E.g.*, Dean F. Hanley and Paul Bork, *Crowdfunding: A New Way to Raise Capital, or a Cut-Back in Investor Protection?*, 26 *INSIGHTS* 44, 45 (2012), (describing the activity permitted under the CROWDFUND Act as “equity crowdfunding”); Loten, *supra* note 53, at B1 (reporting that “Congress in April passed a new law that would allow ‘equity crowdfunding’”).

155 Of course, if a majority of the equity is sold to the public, then the dangers cited in Part II.B, *supra*, will also come into play.

156 *See generally* Andrew A. Schwartz, *The Perpetual Corporation*, 80 *GEO. WASH. L. REV.* 764, 768–70 (2012) (describing “limited liability”).

1. Problems with Issuing Equity to Strangers

a. Shareholder Derivative Actions

Selling stock exposes directors and officers to being sued personally in a shareholder derivative action for breach of fiduciary duty.¹⁵⁷ The two main fiduciary duties placed on managers are the duty of care and the duty of loyalty.¹⁵⁸ The duty of care requires managers to “invest a certain amount of time and effort and exercise a certain level of skill and judgment in the operation of the firm,” while the duty of loyalty requires managers to “put the interests of the stockholders ahead of their personal gain and subjects them to oversight in transactions involving conflicts of interest.”¹⁵⁹ A violation of either duty exposes the manager to unlimited personal liability for the corporation’s losses.¹⁶⁰

Disgruntled shareholders have no difficulty finding legal representation and, as a result, businesses constantly fear the threat of shareholder suits.¹⁶¹ Further, due to the high costs of litigation, the vast majority of shareholder lawsuits end in settlements,¹⁶² sometimes

157 Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 927–28 (1983).

158 Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 32 (1996); Scott, *supra* note 157, at 932 (“[T]he duty of care . . . requires a corporate officer . . . [or] a corporate director[] ‘to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.’” (internal citation omitted)).

159 Scott, *supra* note 157, at 927–28.

160 *Id.* at 928, 933. *But cf. id.* (noting that very few cases have imposed liability solely on the basis of a violation of the duty of care due to the business judgment rule, preventing judges from second-guessing corporate decision-makers); *see* DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2011) (permitting the exculpation of personal monetary liability for violations of the duty of care).

161 *See* Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 DEL. J. CORP. L. 1, 4–6 (1999); *see also* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 149–62 (2004) (noting that due to the substantial attorney fees often awarded, plaintiff attorneys often actively seek out potential clients willing to bring an action against a corporation in which they own stock); Joann S. Lublin, *Venture Capitalist: Beware of Activist Holders*, WALL ST. J., July 11, 2012, at B5 (relaying an interview with corporate officer in which he describes “people who owned the company suing . . . really frivolously”).

162 James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Actions Settlements*, 58 STAN. L. REV. 411, 418 (2005).

resulting in the surrender of large sums of money¹⁶³ to a shareholder bringing a borderline frivolous case.¹⁶⁴

In practice, nearly all businesses owing fiduciary duties to shareholders purchase directors' and officers' ("D&O") insurance,¹⁶⁵ which covers the full costs of corporate and individual director and officer liability, including attorneys' fees.¹⁶⁶ Although premium rates for D&O insurance are not disclosed,¹⁶⁷ it is clear that to be sufficiently covered, a business will have to spend a considerable amount on insurance.¹⁶⁸ Thus, even if the managers do not fear personal liability from shareholder derivative actions, the corporation will incur increased costs by issuing equity.

In short, the specter of personal liability and expensive D&O insurance that accompany the offering of stock is a significant disincentive to issuing it in the first place.

b. Demands for Books and Records

Because shareholders own the corporation, they are given the right to inspect the actions of those managing it.¹⁶⁹ Therefore, a shareholder has a right to inspect corporate books and records for any proper purpose,¹⁷⁰ and "officers and directors have no legal authority to close the office doors and books to shareholders for whom they are only agents."¹⁷¹ This presents yet another inconvenience for a company with outstanding stock, as "shareholders some-

163 Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 495–96, n.33 (2007) (noting the average settlement value of shareholder class actions in 2005 was \$24 million, while the median was \$7 million, and only 27% settled for less than \$3 million (the data sample included both fiduciary duty claims and securities law claims)).

164 Loewenstein, *supra* note 161, at 4; *see also* Thompson & Thomas, *supra* note 161, at 153 (commenting that it is often economically rational for defendants to settle even frivolous cases).

165 Baker & Griffith, *supra* note 163, at 487.

166 Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1797 (2007).

167 Baker & Griffith, *supra* note 163, at 535–37.

168 *Id.* at 503 (noting that in 2005, small-cap companies purchased an average of \$28.25 million in D&O coverage limits, and the amount of coverage purchased increased as the size of the company increased).

169 *See generally* Randall S. Thomas, *Improving Shareholder Monitoring and Corporate Management By Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 331–49 (1996); C.C. Bjorklund, *Proper Purpose for Shareholder's Inspection of Corporate Books and Records*, 24 AM. JUR. PROOF OF FACTS 2D 71 § 3 (1980).

170 COX & HAZEN, *supra* note 117, § 13:2.

171 *Id.*

times arrive with their attorneys, auditors, and accountants when demanding to see all the records, and hope to find some alarming misconduct they can communicate to other shareholders.”¹⁷² Corporations are thus advised to maintain meticulous books and records and to brace for the costs of litigating such requests.¹⁷³

If, in response to a shareholder request for books and records, the corporation refuses to turn them over, the shareholder can make the demand through the courts,¹⁷⁴ and will usually prevail so long as their purpose for the demand is proper.¹⁷⁵ Courts have considered numerous purposes to be “proper,” including

to ascertain (1) the financial condition of the company or the propriety of dividends; (2) the value of shares for sale or investment; (3) whether there has been mismanagement; (4) to obtain, in anticipation of a shareholders’ meeting, a mailing list of shareholders to solicit proxies or otherwise influence voting; or (5) information in aid of litigation with the corporation or its officers involving corporate transactions.¹⁷⁶

As a result, corporations are commonly ordered at the close of litigation to promptly produce the requested documents.¹⁷⁷ And in such a case, beyond the direct cost of disclosing detailed books and

172 *Id.*; William Savitt, *The Battle Over Corporate Books and Records*, NAT’L L.J. 12 (June 18, 2012), available at <http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.21954.12.pdf> (reporting that requests for corporate books and records have recently become a “flashpoint in stockholder litigation”).

173 S. Mark Hurd & Lisa Whittaker, *Books and Records Demands and Litigation: Recent Trends and Their Implications for Corporate Governance*, 9 DEL. L. REV. 1, 33 (2006).

174 Thomas, *supra* note 169, at 347–49 (describing Delaware’s procedure); Bjorklund, *supra* note 169, § 5 (“[I]f the plaintiff or petitioner in a mandamus proceeding prevails, the court issues a writ that . . . orders production of the records for inspection.”).

175 See generally Hurd & Whittaker, *supra* note 173 (providing examples of situations in which the courts have ordered corporations to produce books and records to shareholders).

176 COX & HAZEN, *supra* note 117, § 13:3; see also *id.* (“[S]hareholders generally have a common law right to inspect the books and papers of the corporation without first showing any particular dispute or proving any mismanagement or other circumstance rendering an examination proper.”); *id.* §13:2 (“[W]hen an inspection by a shareholder is contested, the burden is usually held to be on the corporation to establish a probability that the applicants are attempting to gain inspection for purposes not connected with their interests as shareholders or that their purpose is otherwise improper.”).

177 See Hurd & Whittaker, *supra* note 173, at 3.

records,¹⁷⁸ there is the additional concern that confidential company information may become exposed in the process.¹⁷⁹

Thus, the shareholder right to demand books and records from the corporation is another downside to crowdfunding equity.

c. Shareholder Resolutions

In most states, shareholders, regardless of their stake in the company,¹⁸⁰ have the right to propose precatory shareholder resolutions in the company's proxy statement.¹⁸¹ Although these resolutions are merely precatory (that is, non-binding), the threat of "pressure tactics," bad publicity, and poor shareholder relations¹⁸² makes it very difficult for managers to simply ignore these requests.¹⁸³ As a result, many companies have become more responsive to these proposals,¹⁸⁴ adding the inconvenience of having to consider and respond to the demands of shareholders.¹⁸⁵

Most relevant to crowdfunding, the influence of shareholder proposals has been increased by use of the Internet.¹⁸⁶ The Internet has "greatly enhanced the ability of shareholders to communicate . . . with each other, and with management, at little cost,"¹⁸⁷ and "[a] number of shareholder groups and activists . . . now maintain websites, on which shareholder proposals and their status are tracked."¹⁸⁸ Because crowdfunding will likely be conducted exclusively over the Internet, shareholder groups and activists could potentially put links

178 COX & HAZEN, *supra* note 117, § 13:4 (books can include stock ledger or list of shareholders, books of account, minutes of the meetings of directors and shareholders, and corporate documents).

179 Hurd & Whittaker, *supra* note 173, at 26–31.

180 Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 846 (2005).

181 Brownstein & Kirman, *supra* note 126, at 42.

182 *Id.* at 24.

183 *See generally id.* at 41 ("Any indication of dissatisfaction from a significant shareholder minority is a cause for management concern and [t]he mere making of the proposal forces management to prepare a reply, and in the process, to give some consideration to why it took the position on the issue in the first place." (citations omitted) (alteration in original)).

184 *Id.* at 24.

185 *E.g., id.* at 69 ("Boards have gone to great lengths and have employed innovative techniques to give majority vote resolutions a serious hearing, including inviting experts advocating each side of the position to have a 'debate' in front of the board in order to inform its consideration of majority vote resolutions.").

186 *Id.* at 31–32.

187 *Id.* at 31.

188 *Id.* at 32.

on the funding portals in order to gain support for proposals and resolutions.

Thus, the very same tools that a crowdfunded issuer used to finance itself in the first place—such as social media campaigns—can be expected to be used against the issuer by dissatisfied shareholders. This effect can be expected to be magnified because shareholders will not be able to take advantage of the “Wall Street Rule” and simply sell their shares. Doing so in the first year of ownership is expressly barred by the CROWDFUND Act, and even after that prohibition is lifted, there is unlikely to be any significant market for crowdfunded shares. The upshot is that disgruntled shareholders are more likely to petition management for change in the context of crowdfunded securities than has traditionally been the case for public companies.

The cost, distraction, and inconvenience of precatory shareholder resolutions are yet further reasons not to use the CROWDFUND Act to issue stock.

d. Voting Rights

A share of stock generally provides its holder with a right to vote for the election of directors, to amend the charter or bylaws, and to have a say on fundamental changes in the business, such as a merger or sale of all assets.¹⁸⁹ Although shareholders have the right to attend shareholders’ meeting, most voting is done by proxy,¹⁹⁰ which is “the authority given by one shareholder to another to vote her shares at a shareholders’ meeting.”¹⁹¹

Voting rights are important to shareholders,¹⁹² who are able both to directly impact election outcomes, and to “indirectly influence director behavior and hence corporate affairs by increasing the likelihood that directors will engage with shareholders or otherwise incorporate shareholder concerns in their decision making.”¹⁹³ Thus even minority shareholders can, through their exercise of the vote, distract management from its primary task of growing the business.¹⁹⁴ This amounts to yet another disincentive to the crowdfunding of equity.

189 See Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 418 (2006).

190 *Id.* at 417.

191 COX & HAZEN, *supra* note 117, § 13:26.

192 See Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 814 (2006) (arguing “[t]he vote is the core source of shareholder power”).

193 Fairfax, *supra* note 117, at 1261.

194 See e.g. Lublin, *supra* note 161 (reporting an interview with venture capitalist in which he describes the distractions to management caused by “activist” shareholders).

2. Debt May be Preferable to Equity

Debt may be the preferred security to crowdfund, because it comes with none of the problems just enumerated that are endemic to equity. In contrast with the sale of equity, which creates fiduciary duties and exposes managers to a risk of personal liability, the sale of debt creates no fiduciary duties.¹⁹⁵ Rather, the rights of a debtholder are a matter of contract between her and the corporation to which management is not a party.¹⁹⁶ If the corporation is insolvent, and cannot repay the debt, the debtholders are out of luck and cannot pursue the personal assets of management.¹⁹⁷

Moreover, debtholders possess none of the statutory rights addressed above that are held by shareholders. Absent specific provision in the debt agreement, they cannot demand books and records, cannot propose shareholder resolutions, and do not get a vote in corporate elections.¹⁹⁸ Thus, none of those shortcomings of equity are present in the sale of debt, making the latter an attractive option.¹⁹⁹ And debt also has its attractions for investors as well as issuers. For example, debt is generally simpler to value than equity.

Now, debt has its drawbacks. First off, debt must be repaid, raising significant cash flow concerns and potentially interfering with the ability of a company to profit and grow. This is a serious problem, and one that is totally absent if equity is sold, as equity need never be paid back.²⁰⁰ Furthermore, small, high-risk startup companies might have to pay a very high rate of interest on its debt.²⁰¹

195 BOOTH, *supra* note 70, § 6:5.

196 *Id.* § 6:13.

197 COX & HAZEN, *supra* note 117, § 7:7. Nor can they sue the managers in their capacity as shareholders, assuming they are, because of the foundational rule of “limited liability.” *Id.*

198 Such a right could be granted as a matter of contract, however.

199 Observe, however, that if the debt of the company is greater than the value of its assets, the debtholders may be able to band together and force liquidation, or threaten to do so in exchange for control. Thus, even debt may not fully insulate the founder from the market for corporate control.

200 O’Connell, *supra* note 60 (reporting that online eyewear retailer Warby Parker was funded with cash and debt, and that while in its earliest days “[t]hat debt was somewhat helpful,” the company kept growing and required two subsequent equity raises); see generally Lynn A. Stout, *On the Nature of Corporations*, 2005 U. ILL. L. REV. 253, 255 (“[E]quity investors . . . commit their financial contributions irretrievably to the firm.”).

201 The complicated motives of crowdfunding investors might ameliorate this concern to some extent, as they may accept a lower interest rate than rational financial analysis would dictate. Cf. JOHNSON, *supra* note 3 at 41 (opining that people are willing to contribute to Kickstarter projects, despite the lack of “upside,” in order to

These problems, however, can be staved off by creative drafting of debt instruments. For instance, the issuer may issue bonds that include a “payment-in-kind” provision that allow it to make interest payments with bonds, rather than cash.²⁰² Alternatively, the bonds could be designed to defer significant payments far into the future. And finally, while it is true that debt has downsides for a company, its founder might be more concerned with the increased personal risks associated with equity²⁰³ than with the ability of the business to achieve greatness, and may cause her company to crowdfund debt anyway.

In conclusion, debt may be the security of choice for those that raise capital under the CROWDFUND Act.²⁰⁴ Issuing debt securities allows the founders/managers to maintain control of their company, and make decisions they feel will best serve their interests, while avoiding the burdens imposed upon them by demanding shareholders.²⁰⁵

CONCLUSION

As this Article has shown, the crowdfunding of securities is poised to usher in an exciting new chapter in the history of capital formation in the United States—one in which entrepreneurs can thrive and everyone can participate.

That said, real risks remain, perhaps most notably the risk of fraudulent activity. Fortunately, commentators are carefully attuned to the prospect that con artists will use securities crowdfunding to

achieve “the psychological reward of knowing that their money is helping cultivate another human’s talents” and “the social reward of being seen in public doing just that”).

202 See generally Ryan Dezember and Matt Wirz, *Debt Fuels a Dividend Boom — Firms Collect Payouts and Investors Get Yield*, WALL ST. J., Oct. 19, 2012, at C1 (describing “payment in kind toggle” bonds).

203 See *supra* Part III.B.1.a.

204 Separate and apart from the Securities Act, the Trust Indenture Act generally requires that an issuer of debt register the securities with the SEC. See 15 U.S.C. § 77eee (2006). However, there is an exemption for debt issues of less than \$10 million. See *id.* § 77ddd(a)(9); STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION* 38 (2d ed. 2008). And, as stated above, the maximum financing allowed under the CROWDFUND Act is \$1 million, see *supra* text accompanying note 38, so the Trust Indenture Act will apparently play no role in regulating crowdfunding.

205 It is possible that the sort of person that would be interested making investments via crowdfunding is looking to make a ground floor equity investment in a potential home run start-up. To the extent that this is true, crowdfunding issuers may have trouble selling debt securities, which offer fixed income and limited opportunity for growth.

defraud investors,²⁰⁶ and there is already ample pressure on the SEC to use its broad and ample authority under the CROWDFUND Act to try to minimize fraud.²⁰⁷ Fraud is a valid and important concern, and there is every reason to expect that charlatans will adapt to this new medium.²⁰⁸ Even so, the SEC should tread carefully and try not to embellish the Act with extensive disclosure and other requirements, or it runs the risk of snuffing out securities crowdfunding entirely, not just its fraudulent forms.

In conclusion, as it exercises its rulemaking authority, the SEC should keep in mind that a primary purpose of the Act is to liberate crowdfunding from the costly regulations that have built up over the years for registered offerings. As such, the agency should endeavor to leave the CROWDFUND Act as a simple and lean body of law in order to keep transaction costs down and help democratize access to the capital markets.

206 See, e.g., Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1765-7 (2012) (asserting that, because “social media technologies increase . . . the potential for fraud,” “scammers” can be expected to “tak[e] advantage of investors via crowdfunding”); Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1439 (2012) (referring to “the concern expressed most strongly in the Senate” over “the potential for fraudulent or otherwise abusive offerings”).

207 The SEC is directed by the CROWDFUND Act to issue its rules within 270 days of enactment of the statute, *i.e.*, December 31, 2012. This deadline is unlikely to be met, however, for a number of reasons, including that the CROWDFUND Act requires the SEC to consult with interested state agencies and others, 15 U.S.C.A. § 77 (West Supp. 2012), and that the agency is busy writing many other complex rules. See Loten, *supra* note 53, at B1 (reporting that the SEC “is widely expected to miss that deadline”).

208 See, e.g., Mitchell Zuckoff, *The Perfect Mark*, NEW YORKER, May 15, 2006, available at http://www.newyorker.com/archive/2006/05/15/060515fa_fact (reporting that the FTC received more than 55,000 complaints regarding Nigerian email scams in 2005 alone).